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Notice to Practitioners: Certain Real Estate Lending Activities of Financial Institutions

American Institute of Certified Public Accountants. Task Force on Real Estate Lending Activities of Financial Institutions

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NOTICE TO PRACTITIONERS

Certain Real Estate Lending Activities of Financial Institutions

Prepared by
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Accounting Standards Division
American Institute of Certified Public Accountants

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Notice to Practitioners

Certain Real Estate Lending Activities of Financial Institutions

Financial institutions, particularly savings and loan associations, increasingly are entering into real estate acquisition, development, or construction ("ADC") loans on which they have virtually the same risks and potential rewards as those of owners or joint venturers. AcSEC believes that, in some instances, accounting for such arrangements as loans may not be appropriate and is providing guidance in this notice to assist practitioners in determining the proper accounting.

Arrangements on which AcSEC has noted potential problems are usually structured so that the lender participates in expected residual profit on the ultimate sale or use of the project. Expected residual profit is the amount of profit, whether called interest or another name, above a reasonable amount of interest and fees earned by the lender plus profit for the builder's efforts. The extent of such profit participations and their forms vary. A simple form might be one in which the contractual interest on a condominium project is considered to be a fair market rate, the expected sales prices are sufficient to cover at least principal and accrued interest, and the lender shares in an agreed proportion, for example, 20%, 50%, or 90%, of any profit on sale of the units.

A slightly different form of arrangement may produce

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approximately the same result. For example, the interest rate may be set at a level higher than in the preceding case, and the lender may receive a smaller percentage of any profit on sales of units. Thus, a greater portion of the expected sales price is required to cover the contractual accrued interest, leaving a smaller amount to be allocated between the lender and the owner. In those circumstances, the lender's share of expected residual profits may be approximately the same as in the preceding case. The same result may also occur if the interest rate is set at a sufficiently high level and the lender does not share in a proportion of profit on sale of the units. Another variation might be one in which the lender shares in gross rents or net cash flow from a commercial project, for example, an office building or an apartment complex.

Beyond the lender's participation in expected residual profits, these ADC arrangements usually have most of the following characteristics:

- The lender commits to provide all or substantially all necessary funds to acquire the property and to complete the project. The borrower has title to, but little or no equity in, the underlying property.
- The lender funds the loan commitment or origination fees or both by including them in the amount of the

loan. Often, the transaction is structured to maximize the immediate or early recognition of such fees as income.

- The lender completely funds interest during the term of the loan by adding the interest to the loan balance.
- The loan is secured only by the ADC project. The lender has no recourse to other assets of the borrower, and the borrower does not guarantee the debt.
- In order for the lender to recover the in-investment in the project, the property must be sold to independent third parties, the borrower must obtain refinancing from another source, or the property must be placed in service and generate sufficient net cash flow to service debt principal and interest.
- The arrangement is structured so that foreclosure during the project's development is unlikely because the borrower is not required to fund any payments until the project is complete and, therefore, the loan cannot become delinquent.

AcSEC believes that the following factors tend to change the nature of the risks and rewards of an arrangement that otherwise may be similar to a real estate investment. Those factors should be considered as indications that the risks and rewards are similar to those expected to be associated with a loan:

- The borrower has a substantive equity investment in the project that is not funded by the lender. The investment may be in the form of cash payments by the borrower or contribution by the borrower of land (without considering value expected to be added by future development or construction), or other contributed assets, or, during construction, a reasonable compensation for the builder's efforts not funded by the lender. (If the financial institution is the seller of the property, gain recognition, if any, should be determined by reference to FASB Statement No. 66.)
- The lender has recourse to substantive net assets of the borrower other than the ADC project or the borrower has provided an irrevocable letter of credit to the lender for the full amount of the loan and the entire term of the loan.

- A take out commitment for the full amount of the financial institution's loan(s) has been obtained from a substantial, independent third party. Take out commitments often are conditional. If so, the conditions must be reasonably attainable.
- Noncancellable sales contracts or lease commitments are currently in effect that, on completion of the project, will provide sufficient net cash flow to service normal loan amortization, that is, principal and interest.

If, after considering all of the factors associated with a particular arrangement, the risks and rewards are deemed to be similar to those of an investment in real estate, a majority of AcSEC believes the following guidance is appropriate:

- If the lender will receive a majority of the expected residual profit from the project (a determination of that fact will require a critical analysis of all the terms), the lender should account for income or loss from the arrangement as a real estate investment as specified by FASB Statement No. 67, "Accounting for Costs and Initial Operations of Real Estate Projects," and FASB Statement No. 66, "Accounting for Sales of Real Estate."

- If the lender has less than a majority participation in the expected residual profit, the entire arrangement may be in essence a real estate joint venture. Although the provisions of SOP 78-9, "Accounting for Investments in Real Estate Ventures," and FASB Statement No. 34, "Capitalization of Interest Cost," as modified by FASB Statement No. 58 for investments accounted for by the equity method, do not apply explicitly, they may provide useful guidance.

If the risks and rewards are deemed to be similar to those of a loan, interest should be recognized as income as specified in the loan agreement, subject to recoverability under the net realizable value test. SOP 75-2, "Accounting Practices of Real Estate Investment Trusts," and the AICPA audit and accounting guide, Savings and Loan Associations, provide guidance that may be relevant in assessing the recoverability of such loan amounts and accrued interest.

Even if the lender accounts for such an arrangement as a loan, the lender should consider whether immediate recognition of fees that exceed associated costs is appropriate, regardless of how those fees are described. The guidance that should be considered on the treatment of such fees as yield adjustments is contained in the AICPA guides, Audits of Banks and Savings and Loan Associations.